

# South East Water final decision

2018 Water Price Review

29 May 2018

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# Summary

## **In September 2017, South East Water provided a submission to us proposing prices for a five year period starting 1 July 2018**

In December 2017, we released our draft decision on South East Water's price submission.<sup>1</sup> The draft decision set out our initial views on South East Water's proposals, and invited interested parties to make further submissions. We also held a public meeting in February 2018. In addition to a response from South East Water, we received eight written submissions on our draft decision, which are available on our website. A list of these submissions is included in Attachment A to this final decision.

After considering feedback, we have made a price determination for South East Water.<sup>2</sup> The price determination sets out the maximum prices South East Water may charge for prescribed services (or the manner in which its prices are to be calculated, determined, or otherwise regulated) for the five year period from 1 July 2018 (2018–23). This final decision paper sets out our supporting reasons and analysis for the price determination.

Where our final decision on a particular aspect is unchanged from our draft decision, we have not detailed the supporting reasons in our final decision. Rather, we have noted that our final decision confirms the reasons and position we reached in the draft decision.

Where we have reached a different decision to that proposed in our draft decision, or where new information required our consideration, we have set out our reasons in full in this final decision. This final decision should be read in conjunction with our draft decision.

## **On average, customer prices will fall from 1 July 2018**

Our final decision approves a revenue requirement of \$4,483.0 million over the five year period starting 1 July 2018 (see pages 9 and 10).<sup>3</sup> This is \$14.6 million or 0.3 per cent lower than our draft decision, and mainly reflects our updates to the cost of debt, as anticipated in our draft decision.

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<sup>1</sup> Clause 16 of the Water Industry Regulatory Order 2014 (WIRO) requires us to issue a draft decision. South East Water's price submission and our draft decision are available at [www.esc.vic.gov.au/waterpricereview](http://www.esc.vic.gov.au/waterpricereview).

<sup>2</sup> Before the commencement of a regulatory period, clause 10 of the WIRO requires us to make a price determination which determines the maximum prices a water corporation may charge, or the manner in which its prices are to be calculated, determined or otherwise regulated during the regulatory period. See Essential Services Commission 2018, *South East Water Determination: 1 July 2018 – 30 June 2023*, 29 May.

<sup>3</sup> The revenue requirement is the forecast amount a water corporation needs to deliver on customer outcomes, government policy, and obligations monitored by technical regulators including the Environment Protection Authority

On average, South East Water’s prices will fall from 1 July 2018. A summary of approved maximum prices for major services delivered by South East Water is set out on pages 24 and 25. The estimated typical bills for residential customer groups under our final decision are provided in Table A. Not including inflation, compared with 2017–18, the estimated annual bill for a residential owner occupier will fall by around \$70 in 2018–19, and fall by around \$45 for a residential tenant. The bill paid by a customer will vary depending on water use, prices for fixed and variable tariffs, and other charges.

**Table A**      **Estimated typical residential water and sewerage bills**  
\$ million 2018-19

Customer group	Annual water consumption (kL)	2017-18 annual bill	2018-19 annual bill	2022-23 Annual bill
Residential (Owner occupier)	150	\$1,036	\$963	\$963
Residential (Tenant)	150	\$522	\$476	\$476

<sup>a</sup> Following a \$100 rebate paid to customers from a government efficiency review

Note: Typical bills include water and sewerage charges and any applicable rebates based on average water use. Annual bills exclude the parks and drainage charges. Numbers have been rounded.

### South East Water will improve services in key areas

Our final decision approves prices that will allow South East Water to deliver on its customer service commitments, government policy, and obligations monitored by the Environment Protection Authority Victoria and the Department of Health and Human Services.

Some of the ways South East Water plans to improve outcomes for customers are by:

- reducing water and sewerage prices
- providing real-time notification to customers of service disruptions
- reducing the number of steps in the residential water variable tariff from three to two, to help its customers avoid unexpected high bills.

### Some tariff structures will change

Our final decision approves South East Water’s proposed tariff structures, which include some changes to residential water, sewerage and recycled water tariffs.

Victoria and the Department of Health and Human Services. Along with forecast demand, it is an input to calculating the prices to be charged by a water corporation.

Summary

For residential water tariffs, our final decision approves South East Water’s proposed fixed service charge, and a variable component that depends on water use. For the variable component, we have approved South East Water’s proposal to reduce the inclining block from three steps to two. We accept its proposal as it helps to balance affordability for large households, makes charges simpler, and continues to provide customers with some reward for saving water.

For residential sewerage services, our final decision approves South East Water’s proposed fixed service charge and a variable sewage disposal charge. South East Water will reduce the sewage disposal charge by 50 per cent in line with customer preferences.

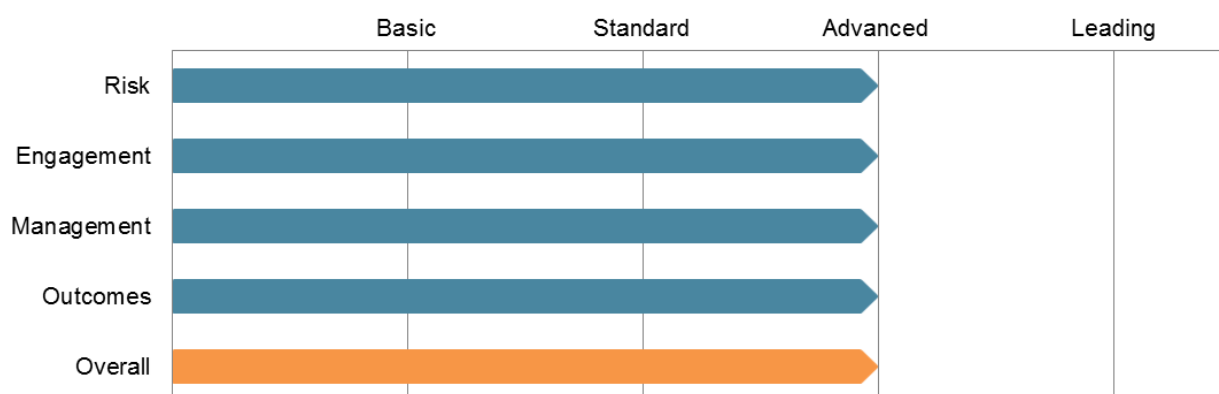
Our final decision also approves South East Water’s proposed tariff basket form of price control that will cover the majority of its tariffs. South East Water currently uses a tariff basket, so our final decision allows for a continuation of the current arrangement.

### South East Water’s price submission is rated as ‘Advanced’ under PREMO

Consistent with our draft decision, our final decision accepts South East Water’s PREMO self-rating of its price submission of ‘Advanced’. Among the factors supporting an ‘Advanced’ rating are South East Water’s efficiency level and forecast improvement rate for operating expenditure, which are high relative to other water corporations. This contributes to the price declines proposed by South East Water for the five years from 1 July 2018, delivering improved value to customers. More detail on our assessment of South East Water’s PREMO rating is provided in Chapter 3.

Figure A summarises our final decision on PREMO. More detail on our assessment of South East Water’s PREMO rating is provided in Chapter 3.

**Figure A** PREMO – South East Water final decision summary



Our PREMO rating is an assessment of the water corporation’s price submission. It is not an assessment of the water corporation itself.





# 1. Our role and approach to water pricing

## **We are Victoria's independent economic regulator**

Our role in the water industry is based on the Water Industry Regulatory Order 2014 (WIRO) which is made under the *Water Industry Act 1994* (Vic) (WI Act) and sits within the broader context of the *Essential Services Commission Act 2001* (Vic) (ESC Act). Our role under the WIRO includes regulating the prices and monitoring service standards of the 19 water corporations operating in Victoria.

## **We are reviewing the prices 17 water corporations propose to charge customers from 1 July 2018**

Our review of the prices proposed by the water corporations covers the prescribed services listed in the WIRO.<sup>4</sup> The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water corporations.<sup>5</sup>

Our task is to assess price submissions by water corporations against the legal framework that governs our role, and make a price determination that takes effect from 1 July 2018. We make a price determination after issuing a draft decision, and considering feedback from interested parties.

The price determination specifies the maximum prices a water corporation may charge for prescribed services, or the manner in which prices are to be calculated, determined or otherwise regulated. We also issue a final decision that sets out the supporting reasons for our price determination.

## **We assess prices against the WIRO and other legal requirements**

Clause 11 of the WIRO specifies the mandatory factors we must have regard to when making a price determination, including matters set out in the WIRO, the WI Act and the ESC Act. In making a price determination for South East Water, we have had regard to each of the matters required by clause 11 of the WIRO, including:

- the objectives and matters specified in clause 8 of the WIRO, which include economic efficiency and viability matters, industry specific matters, customer matters, health, safety, environmental and social matters, and other matters which are specified in sections 8 and 8A of the ESC Act and section 4C of the WI Act

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<sup>4</sup> The review excludes Melbourne Water and Goulburn-Murray Water. In 2016 we approved prices for Melbourne Water to 30 June 2021 and for Goulburn-Murray Water to 30 June 2020.

<sup>5</sup> The prescribed services are listed at clause 7(b) of the WIRO.

- the matters specified in our guidance<sup>6</sup>
- the principle that prices should be easily understood by customers and provide signals about the efficient costs of providing services, while avoiding price shocks where possible
- the principle that prices should take into account the interests of customers of the regulated entity, including low income and vulnerable customers.

Our consideration of legal requirements document lists the specific objectives and the various matters the commission must have regard to when making a price determination and provides a guide to where we have done so for our price determination for South East Water.<sup>7</sup>

In 2016, we issued guidance to South East Water to inform its price submission. The guidance set out how we will assess South East Water's submission against the matters we must consider under clause 11 of the WIRO.

If we consider the price submission has adequate regard for the matters in clause 11 of the WIRO and complies with our guidance, we must approve South East Water's proposed prices.<sup>8</sup>

If we consider the submission does not have adequate regard for the matters specified in clause 11 of the WIRO or comply with our guidance, we may specify maximum prices, or the manner in which prices are to be calculated, determined or otherwise regulated.<sup>9</sup>

The power for water corporations to impose fees is set out in the *Water Act 1989 (Vic)* (Water Act). Provisions in the Water Act also govern the manner in which water corporations may impose fees, and it is for each water corporation to ensure that it complies with them.<sup>10</sup>

## **The 2018 price review is the first we've undertaken under our new water pricing approach**

In 2014, the Victorian Government reviewed and revised the WIRO. The changes allowed us more flexibility to decide on the pricing approach we use in Victoria's water sector. In April 2015 we released a consultation paper to start reviewing our pricing approach.<sup>11</sup>

<sup>6</sup> Essential Services Commission 2016, *2018 Water Price Review: Guidance paper*, November.

<sup>7</sup> Essential Services Commission 2018, *South East Water final decision, 2018 Water Price Review – commission's consideration of legal requirements*, 29 May. This is available at [www.esc.vic.gov.au/waterpricereview](http://www.esc.vic.gov.au/waterpricereview).

<sup>8</sup> This is a requirement of the WIRO, clause 14(b).

<sup>9</sup> This is provided for under the WIRO, clause 14(b)(i).

<sup>10</sup> See Part 13, Division 5 of the Water Act.

<sup>11</sup> Essential Services Commission 2015, *Review of Water Pricing Approach: Consultation paper*, April.

Over 2015, we held a series of workshops and hosted a conference (in November) to hear from stakeholders and explore alternative ways to approach water pricing.

In May 2016, we released a position paper setting out our proposed new pricing approach, and invited submissions.<sup>12</sup> We met with each water corporation and other interested parties to help inform their submissions. Submissions were supportive of the overall proposal, in particular the greater focus on customer engagement and value.

We finalised our new approach to water pricing in October 2016.<sup>13</sup>

Our new pricing approach builds on many aspects of the previous approach. We continue to use the building blocks to estimate the revenue requirement for a water corporation.<sup>14</sup> Our guidance explains the building blocks and how we use it to estimate the revenue requirement.<sup>15</sup>

Among the key changes, the new approach introduces new incentives to help ensure water corporations deliver the outcomes most valued by customers. Our new PREMO framework rewards stronger customer value propositions in price submissions, and an early draft decision is available for price submissions we can assess in a short timeframe.<sup>16</sup> The PREMO incentive is described next.

Our consultation on the pricing approach informed the guidance we issued water corporations in November 2016 to inform price submissions for the 2018 water price review.

## **PREMO**

PREMO stands for **P**erformance, **R**isk, **E**ngagement, **M**anagement, and **O**utcomes. The purpose of PREMO is to provide an incentive for water corporations to deliver outcomes most valued by customers. It includes incentives for a water corporation to engage with customers to understand their priorities and concerns, and take these into account.

PREMO links the return on equity allowed in the revenue requirement to the value delivered by a water corporation to its customers. Under PREMO, a higher level of ambition in terms of delivering customer value results in a higher return on equity.

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<sup>12</sup> Essential Services Commission 2016, *A new model for pricing services in Victoria's water sector: Position paper*, May.

<sup>13</sup> For more detail on the new water pricing approach see: Essential Services Commission 2016, *Water Pricing Framework and Approach: Implementing PREMO from 2018*, October.

<sup>14</sup> The revenue requirement is the forecast amount that a water corporation needs to deliver on customer outcomes, government policy, and obligations monitored by technical regulators including the Environment Protection Authority Victoria and the Department of Health and Human Services.

<sup>15</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 8–9.

<sup>16</sup> In December 2017 we issued early draft decisions for East Gippsland Water, South East Water, Westernport Water and Yarra Valley Water.

The 2018 water price review is the first time we've applied our PREMO incentive mechanism. A water corporation's ambition in terms of delivering customer value is being assessed against four elements of PREMO – Risk, Engagement, Management and Outcomes.<sup>17</sup>

A water corporation must self-assess and propose a rating for its price submission as 'Leading', 'Advanced', 'Standard' or 'Basic'. Its proposed return on equity will then reflect its PREMO rating. A 'Leading' submission has the highest return on equity, and a 'Basic' submission the lowest. We assess the justification for the PREMO rating, and also rate the price submission. This process determines the return on equity reflected in the revenue requirement.<sup>18</sup>

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<sup>17</sup> The Performance element of PREMO will be assessed at the review following the 2018 water price review.

<sup>18</sup> The PREMO process is described in: Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 44–49.

## 2. Our assessment of South East Water's price submission

We have made our price determination for South East Water after considering: South East Water's price submission, its responses to our queries and our draft decision, and written submissions from interested parties, including in response to our draft decision (a list of submissions responding to our draft decision is provided in Appendix A). We also held a public meeting in February on our draft decision to receive feedback.

Any reports, submissions, or correspondence provided to us which are material to our consideration of South East Water's price submission are available on our website (to the extent the material is not confidential).

South East Water's price submission and financial model presented clear and comprehensive information to support its proposals. South East Water also provided evidence that its engagement sought to capture the main priorities and concerns of customers, and that it has taken this feedback into account (see customer engagement on pages 6 and 7).

Our guidance included a number of matters water corporations must address in their price submissions. South East Water's price submission addressed each of these matters, with our initial assessment set out in our draft decision. Our final decision is set out on the following pages.

All financial values referred to in this chapter are in \$2017-18, unless otherwise specified.

## Regulatory period

Our draft decision accepted the five year regulatory period (1 July 2018 to 30 June 2023) proposed by South East Water in its price submission. Our guidance proposed to approve a five year regulatory period, subject to any alternative and justified proposal.<sup>19</sup>

In response to our draft decision, Consumer Action Law Centre recommended the regulatory period should be the same for all water corporations, unless there are special circumstances.<sup>20</sup> In support of this, it noted factors such as greater community attention when all price reviews are undertaken at the same time.

Our final decision is to approve the five year regulatory period proposed by South East Water. This is the same period we have approved for the other three final decisions released at this time.

## Customer engagement

The engagement by South East Water:

- took place between August 2016 and September 2017
- used a range of methods including an online survey, deliberative online discussions, an online bill simulator, focus groups, workshops and a consultation panel
- was informed by a customer consultation committee which South East Water used to challenge, advise and influence its engagement program<sup>21</sup>
- covered matters such as customer willingness to pay for certain services, tariffs and Guaranteed Service Levels.

More information about South East Water's engagement<sup>22</sup> is available in its price submission.

Evidence that South East Water's engagement influenced its submission includes its proposals to:

- reduce the number of steps in its residential water variable tariff from three to two, in response to customer feedback on the impact of the existing structure on large households

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<sup>19</sup> For detail on the reasons for using five years as the default regulatory period, see: Essential Services Commission 2016, *Guidance paper*, op. cit., p. 21.

<sup>20</sup> Consumer Action Law Centre 2018, *Submission: Comment on Early Draft Decisions*, 13 March, pp. 5–6.

<sup>21</sup> South East Water's price submission included a letter from the committee that supported the corporation's engagement approach.

<sup>22</sup> See Appendix 3 of South East Water's price submission, available at [www.esc.vic.gov.au/waterpricereview](http://www.esc.vic.gov.au/waterpricereview).

- invest in digital notifications such as website and SMS alerts in response to feedback that customers valued early notification of service issues.

The influence of South East Water's engagement on its proposals supports the objectives in our pricing framework relating to efficiency and the interests of consumers.<sup>23</sup>

In a submission responding to our draft decision, Consumer Action Law Centre suggested we could play a greater role to promote best practice customer engagement and identify areas for improvement.<sup>24</sup> We note that following our price review, we will continue to work with water corporations to promote best practice customer engagement.

## Outcomes

The outcomes South East Water proposes to deliver over the five year period starting 1 July 2018 are:

- get the basics right, always
- warn and inform customers
- fairness and affordability for all
- make the customer experience better
- support its community, protect its environment.

Some of the ways South East Water plans to improve outcomes for customers are by:

- reducing water and sewerage prices
- providing real-time notification to customers of service disruptions
- reducing the number of steps in the residential water variable tariff from three to two, to help its customers avoid unexpected high bills.

South East Water's proposed activities and measures for reporting against these outcomes are set out at pages 18 to 44 of its price submission, with specific targets listed on page 6. South East Water has committed to reporting on its performance of outcomes quarterly to customers. Information will be available on its website and provided with billing information.

South East Water has committed to returning funds to customers if it materially underperforms relative to its targets. More detail is available at page 45 of its price submission.

In early 2018-19, we will engage with South East Water to finalise the set of measures, targets and how it will report to customers on its performance against Outcomes. Its performance will inform

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<sup>23</sup> See for example, WIRO clauses 8(b)(i), 8(b)(ii), 8(b)(iii), 11(d)(iii), and ESC Act Sections 8(1), 8A(1)(a).

<sup>24</sup> Consumer Action Law Centre 2018, *Early Draft Decisions*, op. cit., p. 4.

our assessment during future price reviews as part of the Performance element of PREMO assessments.

## Service Standards

South East Water has also provided a list of service standards relating to reliability and attending faults that it will include in its customer charter. These service standards and South East Water's targets until 2023 are set out in Appendix B.

In a submission on our draft decision Consumer Action Law Centre noted a range of ambitions by water corporations when it comes to proposed service standards and that water corporations should be encouraged to 'improve service standards over time'.<sup>25</sup> We note that South East Water proposed standards for reliability and attending faults are consistent with past targets, and that these service levels are supported by the findings of its customer engagement.

We accept there are arguments for maintaining or decreasing service levels over time particular where engagement identifies customers are satisfied with the existing level of service or do not support increasing expenditure to deliver improved service. We expect water corporations to consider customer preferences when forming these service targets.

Service standards relating to reliability and attending faults are set out in Appendix B and form part of the manner in which South East Water's services are regulated.

## Guaranteed service levels

Guaranteed service levels (GSLs) define a water corporation's commitment to deliver a specified level of service. For each GSL, a water corporation commits to a payment or a rebate on bills to those who have received a level of service below the guaranteed level. We expect water corporations to include GSLs in its customer charter.

South East Water's proposed GSLs are set out at pages 47 and 48 of its price submission. It proposed to increase the rebate amount for its payment difficulty GSL from \$300 to \$500, revise seven existing GSLs, and introduce a new one related to the impact on the local community of a spill caused by South East Water that results in the closure of a beach. Revisions include increasing payments for existing GSLs where it does not deliver on the specified service level.

Our draft decision provided an overview of South East Water's proposed GSLs.

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<sup>25</sup> Consumer Action Law Centre 2018, *Early Draft Decisions*, op. cit., p. 7.



In a submission responding to our draft decision, Consumer Action Law Action Centre supported increasing payments for GSLs so they are 'not losing their value over time'.<sup>26</sup> We note South East Water proposed to increase the payment amounts for all existing GSLs, to reflect inflation.

South East Water's proposed GSLs were informed by its customer engagement. We consider the proposed GSLs reflect the most important aspects of service delivery identified by customers.

For these reasons, our final decision approves South East Water's proposed GSLs.

South East Water's GSLs are set out in Appendix C.

South East Water's commitment to GSL payments should these service levels not be met, forms part of the manner in which South East Water's services are regulated.

## Revenue requirement

The revenue requirement is the forecast amount a water corporation needs to deliver on customer outcomes, government policy, and obligations monitored by technical regulators including the Environment Protection Authority Victoria and the Department of Health and Human Services.<sup>27</sup> Along with forecast demand, it is an input to calculating prices.

Our draft decision proposed a revenue requirement of \$4,497.7 million over the five year period starting 1 July 2018.

Our final decision approves a lower revenue requirement of \$4,483.0 million. This reflects our final decision on each element that comprises the revenue requirement, as set out in Table 2.1.

The reduction in our final decision is mainly due to adjustments we made to South East Water's forecast return on assets, which reflects the updates to the cost of debt anticipated in our draft decision (see pages 18 to 19). Adjustments to the revenue requirement since our draft decision are set out at Table 2.2, with the reasons set out in the following sections.

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<sup>26</sup> Consumer Action Law Centre 2018, *Early Draft Decisions*, op. cit.

<sup>27</sup> We met with officers of the Department of Environment, Land, Water and Planning, Department of Health and Human Services, and Environment Protection Authority Victoria, to discuss their expectations of South East Water in the regulatory period from 1 July 2018. We had regard to their views in our draft and final decisions.

**Table 2.1 Final decision – Revenue requirement**

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Operating expenditure	667.7	662.5	652.1	652.3	652.4	3,286.9
Return on assets	140.7	145.8	149.8	153.3	156.8	746.5
Regulatory depreciation	58.9	67.0	75.5	83.5	90.8	375.7
Tax allowance	13.2	14.3	15.4	15.1	16.0	74.0
<b>Final decision – revenue requirement</b>	<b>880.5</b>	<b>889.6</b>	<b>892.8</b>	<b>904.2</b>	<b>916.0</b>	<b>4,483.0</b>

Note: Numbers have been rounded

**Table 2.2 Adjustments to draft decision revenue requirement**

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
<b>Draft decision – revenue requirement</b>	<b>880.6</b>	<b>893.1</b>	<b>896.1</b>	<b>907.9</b>	<b>920.0</b>	<b>4,497.7</b>
Operating expenditure	3.6	0.3	0.5	0.16	-0.03	4.4
Return on assets	-3.1	-3.1	-3.2	-3.2	-3.3	-15.9
Regulatory depreciation	-0.3	-0.3	-0.3	-0.3	-0.3	-1.3
Tax allowance	-0.3	-0.4	-0.4	-0.4	-0.4	-1.8
<b>Total adjustments</b>	<b>-0.1</b>	<b>-3.5</b>	<b>-3.4</b>	<b>-3.7</b>	<b>-4.0</b>	<b>-14.6</b>
<b>Final decision – revenue requirement</b>	<b>880.5</b>	<b>889.6</b>	<b>892.8</b>	<b>904.2</b>	<b>916.0</b>	<b>4,483.0</b>

Note: Numbers have been rounded

## Operating expenditure

Operating expenditure is an input to the revenue requirement. In our draft decision (pages 9 to 13), we proposed to accept South East Water's operating expenditure forecast of \$3,282.5 million for the 2018–23 period. The reasons for this were:

- Evidence indicating its baseline controllable operating expenditure reflects an efficient benchmark.<sup>28</sup>
- The relatively high efficiency improvement rate of 2.3 per cent per year, which matches its forecast growth of 2.3 per cent per year.
- South East Water has absorbed forecast increases in wages (above inflation) and electricity prices within its proposed efficiency improvement targets, whereas some other corporations have sought additional expenditure for these items. South East Water justified the additional expenditure for improving its information technology security, maintenance and testing for Aquarevo, and increased operating costs following upgrades to two of its recycling plants.

We noted in our draft decision that we would update the forecast non-controllable operating expenditure for our final decision, and also adjust for the latest inflation and external bulk charges data.<sup>29</sup>

South East Water's response to our draft decision advised of a minor correction to its baseline controllable operating expenditure for 2016-17 to ensure consistency with the regulatory accounts. The \$0.18 million increase in the 2016-17 baseline year costs resulted in an increase of \$0.19 million per year for the annual adjusted baseline from 2018-19 to 2022-23. We accept South East Water's correction for our final decision and we have increased controllable operating expenditure by \$0.93 million compared to our draft decision.

No other new considerations were presented in submissions received following the draft decision which caused us to change our views on operating expenditure.

For non-controllable operating expenditure, we have adjusted South East Water's forecasts where required based on the latest information received from the relevant regulatory authorities on their licence fees and the environmental contribution. We have also taken into account the latest data on inflation and external bulk charges.

For the environmental contribution, we have used the 2018-19 value provided by the Department of Environment, Land, Water and Planning and assumed that this will remain flat in nominal terms (decline in real terms) across the 2018–23 regulatory period.

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<sup>28</sup> Controllable costs are those that can be directly or indirectly influenced by a water corporation's decisions.

<sup>29</sup> Non-controllable costs are those that cannot be directly or indirectly influenced by a water corporation's decisions.

We have assumed the licence fees for the Department of Health and Human Services, the Environment Protection Authority Victoria and the Essential Services Commission remain flat in real terms across the period, but with a 50 per cent increase for our commission fee in 2022-23 to align with our regulatory review cycle.<sup>30</sup>

We have increased South East Water's forecast non-controllable operating expenditure by \$3.49 million across the 2018–23 period, resulting from the following adjustments:

- decreasing the Department of Health and Human Services licence fee by \$0.007 million per year (a total decrease of \$0.03 million)
- adopting a forecast for our commission licence fee of \$0.55 million per year for 2018-19 to 2021-22, and \$0.83 million in 2022-23 (a total reduction of \$0.56 million)
- increasing the Environment Protection Authority Victoria licence fee by \$0.009 million per year (a total increase of \$0.04 million)
- adopting a forecast for the environmental contribution of \$0.16 million in 2018-19 and 2019-20, and assuming the contribution increases by \$0.15 million per year over 2020-21 to 2022-23 (a total increase of \$0.76 million)
- increasing external bulk water and sewerage charges by \$3.29 million in 2018-19 based on Melbourne Water's recently approved tariffs for that year.

Overall, non-controllable operating expenditure will increase by \$17.72 million from 2017-18 to 2018-19, due primarily to the increase in the environmental contribution from \$27.86 million to \$39.93 million and the increase in external bulk charges from \$496.84 million to \$502.72 million.

Table 2.3 sets out our proposed adjustments for non-controllable operating expenditure. Table 2.4 sets out the benchmark values for licence fees we have adopted for our final decision.

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<sup>30</sup> The Department of Health and Human Services and the Environment Protection Authority Victoria provided their latest 2016-17 licence fees. We have also based our forecast on our 2016-17 commission licence fee.

**Table 2.3 Adjustments to operating expenditure**

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
<b>Draft decision – total operating expenditure</b>	<b>664.1</b>	<b>662.2</b>	<b>651.6</b>	<b>652.1</b>	<b>652.4</b>	<b>3,282.5</b>
Correction to baseline operating expenditure	0.19	0.19	0.19	0.19	0.19	0.93
<b>Total adjustments to controllable costs</b>	<b>0.19</b>	<b>0.19</b>	<b>0.19</b>	<b>0.19</b>	<b>0.19</b>	<b>0.93</b>
Licence fees	-0.07	-0.07	0.12	-0.17	-0.36	-0.56
Environmental contribution	0.16	0.16	0.15	0.15	0.15	0.76
External bulk charges	3.29	0.00	0.00	0.00	0.00	3.29
<b>Total adjustments to non-controllable costs</b>	<b>3.38</b>	<b>0.08</b>	<b>0.28</b>	<b>-0.02</b>	<b>-0.22</b>	<b>3.49</b>
<b>Final decision – total operating expenditure</b>	<b>667.7</b>	<b>662.5</b>	<b>652.1</b>	<b>652.3</b>	<b>652.4</b>	<b>3,286.9</b>

Note: Numbers have been rounded

We have adopted the benchmark for operating expenditure set out in Table 2.4 for the purpose of making our final decision on South East Water’s revenue requirement (Table 2.1). We consider South East Water’s approach to forecasting controllable operating expenditure and its \$0.93 million correction, alongside our \$3.49 million increase to the non-controllable expenditure, are consistent with the requirements of the Water Industry Regulatory Order 2014 (WIRO) and the criteria for prudent and efficient expenditure outlined in our guidance.<sup>31</sup>

<sup>31</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., p. 31.

**Table 2.4 Final decision – Operating expenditure**  
\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
<b>Controllable costs</b>	<b>123.7</b>	<b>124.0</b>	<b>125.1</b>	<b>125.4</b>	<b>125.4</b>	<b>623.6</b>
<b>Non-controllable costs</b>	<b>544.0</b>	<b>538.4</b>	<b>527.0</b>	<b>526.9</b>	<b>527.0</b>	<b>2,663.3</b>
Bulk services <sup>a</sup>	502.7	498.1	487.5	488.2	488.9	2,465.4
Environmental contribution <sup>b</sup>	39.9	39.0	38.2	37.3	36.5	190.9
Licence fees – ESC <sup>c</sup>	0.55	0.55	0.55	0.55	0.83	3.03
Licence fees – DHHS <sup>c</sup>	0.26	0.26	0.26	0.26	0.26	1.31
Licence fees – EPA <sup>c</sup>	0.08	0.08	0.08	0.08	0.08	0.38
Other	0.4	0.4	0.5	0.5	0.5	2.3
<b>Final decision – operating expenditure</b>	<b>667.7</b>	<b>662.5</b>	<b>652.1</b>	<b>652.3</b>	<b>652.4</b>	<b>3,286.9</b>

<sup>a</sup> Bulk services covers the supply of bulk water and sewerage services

<sup>b</sup> The Environmental Contribution collects funds from water corporations under the *Water Industry Act 1994* (Vic)

<sup>c</sup> Licence fees are paid to cover costs incurred by Department of Health and Human Services, the Environment Protection Authority Victoria, and the Essential Services Commission in their regulatory activities related to the water corporation

Note: Numbers have been rounded

The benchmark operating expenditure that we have adopted for South East Water does not represent the amount that South East Water is required to spend or allocate to particular operational, maintenance and administrative activities. Rather, it represents assumptions about the overall level of operating expenditure (to be recovered through prices) that we consider sufficient to operate the business and to provide services over the regulatory period.

## Regulatory asset base

The regulatory asset base is used to estimate the return on assets and regulatory depreciation in the revenue requirement. Our guidance required South East Water to propose its:

Our assessment

- closing regulatory asset base at 30 June 2017
- forecast regulatory asset base for each year of the regulatory period from 1 July 2018.

### Closing regulatory asset base

We update the regulatory asset base to reflect actual capital expenditure, government and customer contributions, and asset disposals for the period to 30 June 2017. This helps to ensure prices reflect the actual expenditure of a water corporation.

Our draft decision accepted South East Water's proposed closing regulatory asset base for 30 June 2017 of \$3,289.9 million because:

- South East Water's actual net capital expenditure for the period from 2012-13 to 2016-17 was \$292.5 million lower than the forecast used to approve prices for the period from 1 July 2013<sup>32</sup> <sup>33</sup>
- South East Water calculated its closing regulatory asset base in accordance with the requirements of our guidance.

No new considerations were presented in submissions received following the draft decision which caused us to change our views on the closing regulatory asset base.

For the reasons set out above, our final decision approves a closing regulatory asset base at 30 June 2017 of \$3,289.9 million. The calculations are provided at Table 2.5.

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<sup>32</sup> Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure.

<sup>33</sup> We take a risk-based approach to including past capital expenditure in the regulatory asset base. We undertake a prudence and efficiency review where a water corporation has exceeded its net capital expenditure forecasts by more than 10 per cent. We believe this approach is reasonable given capital expenditure can be relatively 'lumpy' in nature.

**Table 2.5 Final decision – Closing regulatory asset base**  
\$ million 2017-18

	2012-13	2013-14	2014-15	2015-16	2016-17
Opening RAB 1 July	2,794.8	2,904.0	3,061.7	3,204.4	3,239.8
Plus gross capital expenditure	187.4	229.4	232.7	149.6	169.5
Less government contributions	0.0	0.0	0.0	0.0	0.0
Less customer contributions	18.7	22.6	31.9	47.8	45.3
Less proceeds from disposals	1.5	1.9	1.8	1.8	3.0
Less regulatory depreciation	58.0	47.2	56.2	64.6	71.1
<b>Closing RAB 30 June</b>	<b>2,904.0</b>	<b>3,061.7</b>	<b>3,204.4</b>	<b>3,239.8</b>	<b>3,289.9</b>

Note: Numbers have been rounded

### Forecast regulatory asset base

The forecast regulatory asset base is calculated having regard to the closing asset base, and forecasts for capital expenditure, government and customer contributions, and asset disposals.

Our draft decision accepted South East Water's forecast regulatory asset base for the period from 1 July 2018, as we were satisfied it met the requirements of our guidance.

In a response to our draft decision, South East Water provided updated forecasts for 2017-18 capital expenditure, lowering the forecast by \$16.1 million to \$168.5 million. We have updated the forecast regulatory asset base to reflect this change, noting that 2017-18 capital expenditure will be verified and updated prior to South East Water's regulatory period from 1 July 2023. The update to capital expenditure means forecast depreciation is also lower than reflected in our draft decision.

Our final decision on South East Water's forecast regulatory asset base is set out at Table 2.6.



**Table 2.6 Final decision – Forecast regulatory asset base**  
\$ million 2017-18

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Opening RAB 1 July	3,289.9	3,342.8	3,469.0	3,592.9	3,662.0	3,762.7
Plus gross capital expenditure	168.5	249.9	253.0	193.7	219.5	195.9
Less government contributions	0.0	0.0	0.0	0.0	0.0	0.0
Less customer contributions	38.4	38.3	38.1	38.0	33.5	33.4
Less proceeds from disposals	1.8	26.6	23.9	11.2	1.8	1.8
Less regulatory depreciation	75.3	58.9	67.0	75.5	83.5	90.8
<b>Closing RAB 30 June</b>	<b>3,342.8</b>	<b>3,469.0</b>	<b>3,592.9</b>	<b>3,662.0</b>	<b>3,762.7</b>	<b>3,832.5</b>

Note: Numbers have been rounded

### Capital expenditure

Capital expenditure is an input to estimating the regulatory asset base. In our draft decision (pages 15 to 18), we proposed to accept South East Water’s gross capital expenditure forecast of \$1,112.0 million for the 2018–23 period. The reasons for this were:

- South East Water’s price submission and business cases provided evidence that its forecasts for capital expenditure are efficient.
- We consider the planned capital expenditure program is achievable, given South East Water’s past track record delivering its capital expenditure program.
- South East Water has an appropriate approach for managing expenditure associated with uncertain projects.
- We consider South East Water’s approach to forecasting its capital expenditure is consistent with the requirements of our guidance.

Our draft decision requested South East Water define the success criteria for the digital water metering pilot before any broader roll-out could proceed. The Consumer Action Law Centre (CALC) strongly supported our position that water corporations must define success criteria and

that a full roll-out should be expected to deliver a positive net present value.<sup>34</sup> In its response to our draft decision, South East Water provided six success criteria for its digital capability pilot, one of which involves identifying further business efficiencies resulting in a positive net present value for the business case, and lower costs for customers over time.<sup>35</sup> We consider South East Water has established an appropriate set of criteria to evaluate its digital meter pilot program before preparing a business case to proceed with a broader roll-out. We expect it will publicly report against these criteria to inform customers before committing to the next stages. As we stated in our draft decision, any expenditure incurred by South East Water beyond the pilot may be subject to a prudence and efficiency assessment before it can be included in the regulatory asset base.

In its submission, CALC recommended the commission sets industry-wide principles to ensure the rollout of smart meters is in the best interest of consumers, including support mechanisms for vulnerable customers.<sup>36</sup> However, our regulatory role is to ensure only efficient costs are recovered from customers through pricing, and does not extend to overseeing the design and delivery of capital projects. We agree with CALC that strong customer engagement and collaboration across the industry is important for achieving an efficient outcome for customers, including vulnerable customers. We also agree water corporations should take into account lessons learnt from the energy smart meter rollout, and from other water corporations further advanced with their digital metering programs.

Our draft decision also requested South East Water provide a revised cost forecast for the Boneo water recycling plant upgrade, because the contract was out to tender at the time of our draft decision. South East Water's response stated that the submissions received in the tender process were consistent with the total expected expenditure and profile included in its price submission.<sup>37</sup> We have verified the tender amounts and accept South East Water's response, noting there is no change to forecast gross capital expenditure.

South East Water's response to our draft decision did not propose any changes to the draft decision's proposed gross capital expenditure. No new considerations were presented in submissions received following the draft decision which caused us to change our views on capital expenditure.

Accordingly, we consider it appropriate to maintain the views we expressed in our draft decision in relation to the gross capital expenditure benchmark for the same reasons proposed in our draft

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<sup>34</sup> Consumer Action Law Centre 2018, *Early Draft Decisions*, op. cit.

<sup>35</sup> South East Water 2018, *Response to the ESC's draft decision on South East Water's price submission*, 9 March.

<sup>36</sup> Consumer Action Law Centre 2018, *Early Draft Decisions*, op. cit.

<sup>37</sup> South East Water 2018, op. cit.

decision. We consider this benchmark is consistent with our guidance and WIRO principles,<sup>38</sup> and is reflected in our final decision on South East Water's forecast regulatory asset base (Table 2.6) and its revenue requirement (Table 2.1).

The benchmark that we adopt for South East Water does not represent the amount that the water corporation is required to spend or allocate to particular projects. Rather, it represents assumptions about the overall level of expenditure (to be recovered through prices) that we consider sufficient to operate the business and to maintain or improve services over the regulatory period. South East Water determines how to best manage the allocation of its revenue and priority of its expenditure within a regulatory period.

In our draft decision, we accepted South East Water's approach for addressing uncertain capital expenditure. We reiterate that South East Water will need to demonstrate the prudence and efficiency of additional costs incurred during the 2018–23 period if seeking to include them in the regulatory asset base.

### **Customer contributions**

Customer contributions are deducted from gross capital expenditure so they are not included in the regulatory asset base.

Our draft decision considered South East Water's forecast revenue from customer contributions was reasonable, having regard to past trends and its growth forecasts. We proposed to accept South East Water's forecast. No other new considerations were presented in submissions received following the draft decision which caused us to change our views on revenue from customer contributions.

For the reasons set out above, we consider it appropriate to maintain the views we expressed in our draft decision. Our final decision accepts the position in our draft decision for the same reasons, and accepts the benchmark revenue from customer contributions as set out at Table 2.6.

### **Cost of debt**

In our draft decision we proposed to approve the cost of debt proposed by South East Water as it used the cost of debt values we specified in our guidance to calculate its revenue requirement. We also noted that we will update the value of the estimated cost of debt for 2017-18 with our calculation of the actual cost, applying the method outlined in our guidance.<sup>39</sup>

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<sup>38</sup> Essential Services Commission 2016, *Guidance Paper*, op. cit., p. 35; WIRO clause 8(b)

<sup>39</sup> We received data on the actual trailing average cost of debt for 2017-18 from Treasury Corporation Victoria in April 2018.

A submission from the Consumer Action Law Centre recommends that we set the benchmark cost of debt at five per cent or around one per cent lower than the amount allowed in our draft decision (6.05 per cent per annum in nominal terms).<sup>40</sup> CALC submits that government owned water corporations carry less risk than private corporations and as such, the allowed cost of debt and the return on equity should be lowered compared with the rates allowed in our draft decision. These recommendations are based on a report prepared by CME for CALC.<sup>41</sup>

A submission by the Water Services Association Australia (WSAA) addressed CALC’s submission.<sup>42</sup> Among other things, WSAA’s submission noted that competitive neutrality principles have been embedded in government policy, including in Victoria via the Financial Accommodation Levy. As a result, water corporations face a cost of debt that reflects the commercial cost of debt.

In keeping with government policy, the approach we take to the cost of debt is to adopt a benchmark rate that applies to all water corporations. The benchmark reflects our estimate of the efficient financing costs for a privately owned business facing a similar degree of economic risk to a regulated water corporation. We consider this is consistent with the requirements of the WIRO.<sup>43</sup>

In our view, adopting the approach recommended by CALC would mean a benchmark efficient water corporation may not have a reasonable opportunity to recover their debt costs.

A more detailed response to the issues raised by CALC is set out at Appendix D.

Our final decision adopts the benchmark cost of debt as set out in Table 2.7.<sup>44</sup>

**Table 2.7 Final decision – Trailing average cost of debt**

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Cost of debt (nominal)	6.9%	7.4%	7.0%	6.3%	5.3%	7.1%	5.4%	5.3%	4.9%	4.5%

Note: Numbers have been rounded

<sup>40</sup> Consumer Action Law Centre 2018, *Submission: Cost of debt and allowed return on equity in the 2018 Water Price Review*, 26 March.

<sup>41</sup> Consumer Action Law Centre 2018, *Cost of debt*, op cit., Appendix A.

<sup>42</sup> WSAA 2018, *WSAA Submission to ESC Cost of debt*, May.

<sup>43</sup> Including, in particular, the requirements that our decision have regard to: the promotion of efficiency in regulated industries and the financial viability of the regulated water industry (cl 8(b)(ii) WIRO); efficiency in the industry and incentives for long term investment (s 8A(1)(a) ESC Act); and consistency in regulation between States and on a national basis (s 8A(1)(f) ESC Act).

<sup>44</sup> We received data on the actual trailing average cost of debt for 2017-18 from Treasury Corporation Victoria in April 2018 and we updated the 2017-18 estimates for our final decision.

## Return on equity – PREMO rating

South East Water rated its price submission as ‘Advanced’. Based on its PREMO self-rating, South East Water proposed a return on equity of 4.9 per cent per annum. This reflects the maximum return rate allowed in our guidance for a price submission rated as ‘Advanced’.<sup>45</sup>

Our draft decision accepted South East Water’s proposed return on equity. This reflected our preliminary review of its PREMO self-rating.

A submission from CALC recommended a one per cent reduction to each return on equity value in the PREMO matrix.<sup>46</sup> CALC’s recommendation is based on the findings of a report prepared by CME. The main reason CME proposed the reduction is due to comparisons with returns allowed for UK water entities, and that government owned water corporations carry less risk than private corporations.

The most relevant comparisons for the return on equity are other economic regulators in Australia. We note the rate for the return on equity (and the regulatory rate of return, comprising the cost of debt and the return on equity) approved in our draft decision are similar to rates recently estimated by other Australian regulators of the water sector.<sup>47</sup> We also consider the allowed return on equity should not be adjusted to reflect government ownership, as the exposure of a water corporation to market risk will not be materially affected by government ownership.

A more detailed response to the issues raised by CALC is set out at Appendix D.

We consider our approach to the return on equity is consistent with our requirements under the WIRO, and in particular, that our estimate provides water corporations with an incentive to invest efficiently, and that our approach has regard to the financial viability of the water industry.

Our final decision accepts South East Water’s proposed return on equity of 4.9 per cent per annum, reflecting our views above, and our final decision on its PREMO rating (Chapter 3).

## Regulatory depreciation

Regulatory depreciation is an input to calculating the regulatory asset base. Our draft decision proposed to accept South East Water’s forecast regulatory depreciation, as it was calculated using a straight line depreciation profile and in a manner consistent with our guidance.

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<sup>45</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., p. 49.

<sup>46</sup> Consumer Action Law Centre 2018, *Cost of debt*, op. cit.

<sup>47</sup> Essential Services Commission of South Australia 2016, *SA Water regulatory determination 2016*, Final Determination, June; Independent Pricing and Regulatory Tribunal 2017, *WACC biannual update*, February.

Following release of our draft decision, South East Water provided an updated capital expenditure forecast for 2017-18. Compared with our draft decision, this update reduced forecast regulatory depreciation for the 2018–23 period by \$1.3 million to \$375.7 million. We have accepted this adjustment for our final decision as it reflects an updated forecast based on latest available information.

No other considerations were presented in submissions received following the draft decision which caused us to change our views on regulatory depreciation.

For the reasons set out above, we consider it appropriate to maintain the views we expressed in our draft decision. Our final decision accepts the position in our draft decision for the same reasons, and accepts the forecasts for regulatory depreciation, as set out in Table 2.1.

## **Tax allowance**

The tax allowance is an input to the revenue requirement. Our draft decision proposed to accept South East Water’s forecast tax allowance as it was calculated in a manner consistent with the method required by our guidance.<sup>48</sup>

Our final decision adopts a slightly lower forecast for the tax allowance, reflecting our final decision on the revenue requirement. No other new considerations were presented in submissions received following the draft decision which caused us to change our views on the tax allowance.

For the reasons set out above, our final decision approves South East Water’s forecast tax allowance, as set out in Table 2.1.<sup>49</sup>

## **Demand**

Our draft decision proposed to approve South East Water’s demand forecasts as we considered they were estimated in a manner that is consistent with the requirements of our guidance. No new considerations were presented in submissions received following the draft decision which caused us to change our views on demand.

For the reasons set out above, we consider it is appropriate to maintain the views we expressed in our draft decision. Our final decision accepts the position in our draft decision for the same reasons, and accepts South East Water’s demand forecasts.

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<sup>48</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 50–51.

<sup>49</sup> Annual tax allowance figures for the revenue requirement differ from our draft decision due to updating the 2017-18 cost of debt.

South East Water's price determination includes the benchmark demand forecasts adopted for our final decision.

## **Form of price control**

Our draft decision proposed to accept South East Water's proposal to continue applying its current form of price control. Accordingly, we proposed to approve a tariff basket covering the majority of its tariffs (with price increases for individual tariffs limited to three per cent per annum, not including inflation), and approve a price cap covering a relatively small number of tariffs.

We considered the proposed form of price control would allow the corporation to recover sufficient revenue to cover the forecast efficient costs of providing services, and for it to deliver on any health, safety, social and environmental obligations. Also, by limiting price increases under its tariff basket, and using a price cap, South East Water's proposal would help to provide customers with price stability, while providing it with revenue certainty.

No other new considerations were presented in submissions received following the draft decision which caused us to change our views on the form of price control.

For the reasons set out above, we consider it appropriate to maintain the views we expressed in our draft decision. Our final decision accepts the position in our draft decision for the same reasons, and accepts South East Water's proposed form of price control.

## **Prices and tariff structures**

Our draft decision accepted South East Water's proposed tariff structures. This included South East Water's proposal to reduce the number of steps in the inclining block tariff that applies to the residential water variable tariff from three to two, and its proposal to reduce the sewage disposal charge applying to residential customers.

Our draft decision considered the two-part tariff structures proposed by South East Water for water services will promote efficient use. We also noted it provides customers a signal about their water use costs, and is an approach that is commonly applied in other states and territories.<sup>50</sup> We also considered two-part tariff structures are easy to understand.

We agreed with South East Water's reasons for reducing the number of steps in the inclining block tariff that applies to the residential water variable tariff as it reduces complexity. We also agreed with South East Water's proposed reduction to the sewage disposal charge for residential

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<sup>50</sup> Includes the tariffs of Icon Water, Sydney Water, Hunter Water, Gosford City Council, Wyong Shire Council, Power and Water Corp, Urban Utilities, Unity Water, SA Water and TasWater.



customers, because we considered the variable sewage disposal charge is difficult to understand and not cost reflective.

A submission responding to our draft decision commented on the impact of the current three tier inclining block tariff structure on households with a large number of residents.<sup>51</sup> We note that South East Water's proposal to reduce the number of steps in the inclining block tariff will better address affordability for larger households by removing the existing higher priced third step.

A submission from a resident within South East Water's service area commented on the manner the water corporation calculates its sewage disposal charge.<sup>52</sup> We note South East Water has proposed to reduce the sewage disposal charge to 50 per cent of the current rate, in part to reduce the bill impact of increased water usage in peak consumption periods or when customers have a leak.

In a response to our draft decision, Mike Vallis noted concern about the mix of fixed and variable charges.<sup>53</sup> As noted in our draft decision, we have provided the water corporations with a large degree of discretion to decide on tariff structures.<sup>54</sup> This recognises water corporations are often best placed to consider the interests of customers in designing tariffs, and that existing tariff structures have been developed over time to deal with a variety of local circumstances.

We have reviewed South East Water's engagement and consider the corporation robustly tested customer views on the balance of fixed and variable charges, to inform its price submission. We note that South East Water's engagement found customers generally wanted to avoid high unexpected bills, and therefore were not supportive of higher variable prices.

Another submission responding to our draft decision raised concern about the general price increases across a range of utility services.<sup>55</sup> Under South East Water's proposal and our final decision, prices for South East Water customers will generally fall. We estimate that typical residential customer bills will fall in 2018–19 by more than \$50 from current levels. South East Water has proposed additional assistance for customers experiencing a bill increase, particularly tenants.

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<sup>51</sup> Phillip Doyle 2018, *Submission*, 16 January.

<sup>52</sup> Anonymous (Brighton) 2018, *Submission*, 12 April.

<sup>53</sup> Mike Vallis 2018, *Submission*, 16 December.

<sup>54</sup> Essential Services Commission 2016, *Guidance paper*, op. cit. p. 55.

<sup>55</sup> Gordon Myers 2018, *Submission*, 5 January.



In its response to our draft decision, South East Water proposed tariffs reflecting our draft decision on its revenue requirement. We consider these proposed tariffs take into account customers' interests, including low income and vulnerable customers, because:

- the proposed tariffs reflect the forecast efficient costs of delivering services
- the proposed two-part structure for water services tariffs will promote efficient water use, and provide customers a signal about the costs of their water use
- the proposed tariffs were informed by an extensive customer engagement program
- the proposed tariffs would allow the corporation to recover revenue sufficient to cover forecast efficient costs
- South East Water has payment options and assistance for customers experiencing difficulty paying bills.

For the reasons set out above, our final decision approves South East Water's proposed tariff structures.

Our price determination for South East Water sets out the maximum prices it may charge for the five year period from 1 July 2018 (or the manner in which its prices are to be calculated, determined, or otherwise regulated for each tariff). Approved maximum prices for water and sewerage services applying to most residential and non-residential customers are set out in Tables 2.8 and 2.9 (in \$2018–19).

**Table 2.8** Final decision – water prices  
\$ 2018-19

	2018-19	2019-20	2020-21	2021-22	2022-23
<b>Residential</b>					
Variable (\$/kL)					
1st tier	2.4441	2.4441	2.4441	2.4441	2.4441
2nd tier	3.1183	3.1183	3.1183	3.1183	3.1183
3rd tier					
Fixed (\$/year)	116.65	116.65	116.65	116.65	116.65
<b>Non-residential</b>					
Variable (\$/kL)					
	3.1183	3.1183	3.1183	3.1183	3.1183
Fixed (\$/year)	116.65	116.65	116.65	116.65	116.65

Note: Numbers have been rounded down

**Table 2.9 Final decision – sewerage charges**  
\$ 2018-19

	2018-19	2019-20	2020-21	2021-22	2022-23
<b>Residential</b>					
Variable (\$/kL)	0.9580	0.9580	0.9580	0.9580	0.9580
Fixed (\$/year)	370.42	370.42	370.42	370.42	370.42
<b>Non-residential</b>					
Variable (\$/kL)	1.8115	1.8115	1.8115	1.8115	1.8115
Fixed (\$/year)	439.91	439.91	439.91	439.91	439.91

Note: Numbers have been rounded down

## Adjusting prices

In our draft decision we accepted South East Water’s proposal to continue its existing:

- uncertain and unforeseen events mechanism
- adjustment mechanisms for desalination water orders and changes to the security charge
- adjustment mechanism for pass-through of other annual changes to Melbourne Water’s bulk water and sewerage prices, including cost of debt adjustments.

Our draft decision also invited South East Water to submit price adjustment formulas that allowed prices to adjust to changes in the cost of debt.

In response to our draft decision, South East Water proposed a price adjustment formula for changes to cost of debt. South East Water’s response also noted that the commission would establish a cost of debt adjustment formula that was consistent across the industry.

Our final decision approves South East Water’s proposal to continue its existing mechanisms on the basis that they are consistent with efficiency objectives, and reflect a continuation of current arrangements.<sup>56</sup> Additionally, our approved cost of debt adjustment formula is set out in our determination for South East Water.

<sup>56</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 59–61.

## **New customer contributions**

New customer contributions (or developer charges) are levied by water corporations when a new connection is made to its water, sewerage or recycled water networks. New customer contributions can be either standard or negotiated. Standard charges apply to new connections in areas where infrastructure requirements and growth rates are relatively well known, while negotiated charges allow water corporations and developers to negotiate a site-specific arrangement.

Our draft decision proposed to accept South East Water's proposal to maintain all standard and area specific new customer contribution charges at the 2017-18 level (plus inflation) until 2022-23 as they are consistent with the requirements of our guidance. We proposed to accept South East Water's proposed use of our new customer contribution pricing principles to calculate negotiated charges.

Our draft decision also proposed to accept South East Water's increase to the base level backlog charge, as it represents a move towards greater cost reflectivity, and to accept the continuation of its existing calculation of brought-forward backlog charges in areas of the Mornington Peninsula.

No other new considerations were presented in submissions received following the draft decision which caused us to change our views on new customer contributions or backlog charges.

For the reasons set out above, we consider it appropriate to maintain the views expressed in our draft decision. Our final decision accepts the position in our draft decision for the same reasons, and accepts South East Water's proposed new customer contribution charges and backlog charges, including its method of calculating negotiated contribution charges and brought forward backlog charges.

Our price determination for South East Water sets out the approved new customer contribution charges and backlog charges for the five year period from 1 July 2018 (or the manner in which its prices are to be calculated, determined, or otherwise regulated).

South East Water should update and publish any development servicing plans and negotiation protocols to assist developers understand the underlying assumptions of its new customer contribution charges.<sup>57</sup>

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<sup>57</sup> Essential Services Commission 2013, *New Customer Contributions: Explanatory Note, December*, pp. 9-11.

## Financial position

In approving prices, we must have regard to the financial viability of the water industry.<sup>58</sup> We interpret the financial viability requirements under the *Essential Services Commission Act 2001* (Vic) and the Water Industry Regulatory Order (2014) to mean that the prices we approve should provide a level of certainty that each water corporation can generate sufficient cash flow to deliver on service commitments, including financing costs arising from investments to meet service expectations.

Our guidance set out key indicators of forecast financial performance. We have reviewed forecasts for these key indicators based on our final decision on South East Water's prices. We have assessed that under our final decision, South East Water will generate sufficient cash flow to deliver on service commitments, including financing costs arising from investments to meet service expectations.

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<sup>58</sup> WIRO clause 8(b)(ii) and ESC Act s.8A(1)(b).

### 3. PREMO rating

PREMO is an incentive mechanism that links the return on equity to a water corporation's level of ambition in delivering value to its customers.

For the 2018 price review, a water corporation must rate its price submission as 'Leading', 'Advanced', 'Standard' or 'Basic'. The rating is based on an assessment against the Risk, Engagement, Management and Outcomes elements of PREMO. A 'Leading' price submission is allowed the highest return on equity, and a 'Basic' the lowest.

The assessment tool included in our guidance directs a water corporation to consider its level of ambition in relation to matters covered in its price submission, such as proposals related to operating and capital expenditure, the form of price control, and tariffs.

In Chapter 2, we noted our final decision is to accept South East Water's proposed return on equity of 4.9 per cent, based on the justification provided for the level of ambition in its price submission. In this chapter, we set out our assessment of South East Water's proposed PREMO rating.

#### Our review of South East Water's PREMO self-rating

South East Water's proposed PREMO rating, and our draft and final decisions are summarised in Table 3.1. After considering submissions in response to our draft decision, our final decision agrees with South East Water's proposed PREMO rating.

**Table 3.1** PREMO Rating

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
South East Water's rating	<b>Advanced</b>	Advanced	Advanced	Advanced	Advanced
Commission's draft decision rating	<b>Advanced</b>	Advanced	Advanced	Advanced	Advanced
Commission's final decision rating	<b>Advanced</b>	Advanced	Advanced	Advanced	Advanced

We agree with South East Water's proposed self-rating for the Risk, Engagement, Management and Outcomes elements of PREMO, for the reasons set out in its price submission.

In particular, we note:

PREMO rating

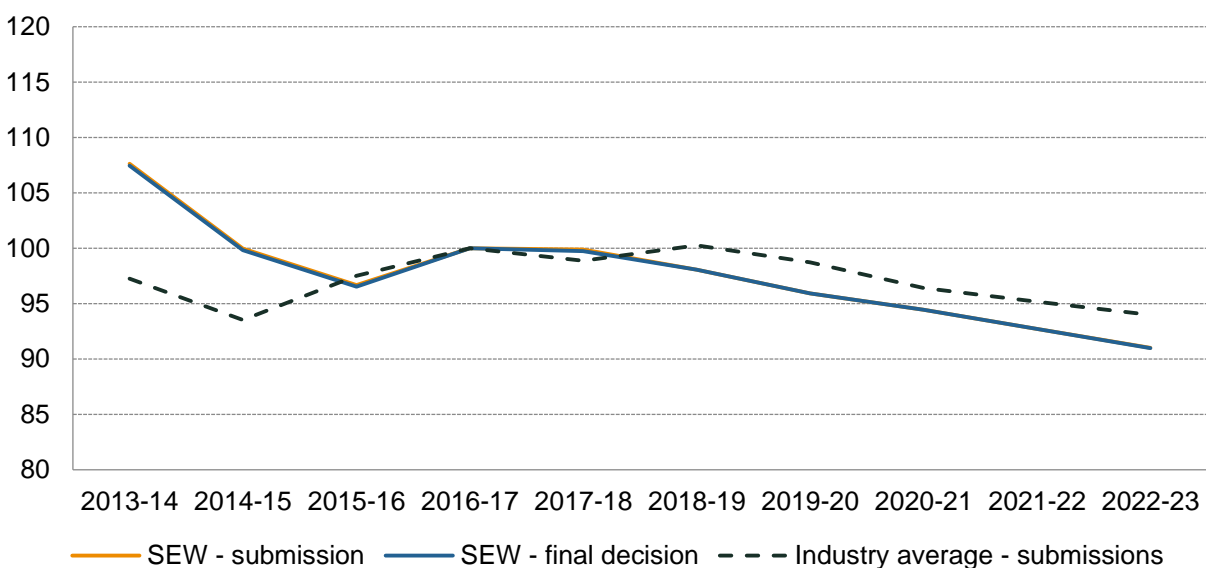
- South East Water’s forecast efficiency improvement rate for controllable operating expenditure, which is high relative to other water corporations, produces a substantial reduction in controllable operating expenditure per customer (Figure 3.1). This contributes to the price declines proposed by South East Water, delivering better value to customers.
- South East Water’s proposed changes to tariffs, including reducing the number of tiers in the inclining blocks for its residential variable water tariff from three to two, and reducing the sewage disposal charge. These changes support customer understanding of tariffs and efficiency.
- South East Water’s engagement program, which included a customer consultation committee. We consider the committee provided important direction and accountability for South East Water’s engagement. South East Water’s price submission included a letter from the committee supporting the corporation’s engagement approach.
- The independent credit rating report provided by South East Water, gave additional assurance about the corporation’s financial position.
- The detail provided in South East Water’s price submission supported its proposed PREMO ratings (see from page 94 of South East Water’s price submission).

While some corrections were needed to South East Water’s financial model, the overall quality of South East Water’s written submission enabled us to assess its proposals relatively quickly and release an early draft decision in December 2017.

We agree with South East Water’s proposed overall PREMO self-rating of ‘Advanced’. This is reflected in the return on equity we have accepted for South East Water at page 20.

**Figure 3.1 Controllable operating expenditure per water connection**

Index: 2016-17=100



## Appendix A – submissions received on draft decision

Name or organisation	Date received
Water Services Association Australia	16 May 2018
Anonymous (Brighton)	12 April 2018
Consumer Action Law Centre	26 March 2018
Consumer Action Law Centre	13 March 2018
Phillip Doyle	16 January 2018
Gordon Meyers	5 January 2018
Mike Vallis	16 December 2017
Environment Protection Authority Victoria	12 December 2017

## Appendix B – approved service standards

We have approved the following standards, and conditions of service and supply, and associated targets for South East Water.

### South East Water's approved service standards

Service standard	2018-19	2010-20	2020-21	2021-22	2022-23
<b>Water</b>					
Customers experiencing more than 5 unplanned water supply interruptions in any 12 month period (number)	532	532	532	532	532
Average time taken to attend bursts and leaks (priority 1) (minutes)	36	36	36	36	36
Average time taken to attend bursts and leaks (priority 2) (minutes)	92	92	92	92	92
Average time taken to attend bursts and leaks (priority 3) (minutes)	317	317	317	317	317
Average duration of unplanned water supply interruptions (minutes)	88	88	88	88	88
Average duration of planned water supply interruptions (minutes)	179	179	179	179	179
<b>Sewerage</b>					
Customers receiving more than 3 sewer blockages in any 12 month period (number)	17	17	17	17	17
Average time to attend sewer spills and blockages (minutes)	47	47	47	47	47
Average time to rectify a sewer blockage (minutes)	137	137	137	137	137
Spills contained within 5 hours (per cent)	100	100	100	100	100

Note: numbers have been rounded.



## Appendix C – approved GSL scheme

We have approved the following service level obligations and corresponding amounts of payment for failure to attain the stated obligation as the guaranteed service level (GSL) scheme for South East Water.

In accordance with clause 13 of the Customer Service Code: Urban Water Businesses, South East Water must ensure that any payment is made to a customer as soon as practical after a customer becomes entitled to the GSL payment.

South East Water is not required to make a payment where the failure to meet the service level is due to the action or inaction of the customer or a third party. For the avoidance of doubt, third party does not include any person or firm acting on behalf of South East Water.

### South East Water's approved GSL scheme

Approved service level obligation	Approved payment (\$)
More than five unplanned water supply interruptions in any 12 month period (from 2018-19 for every water supply interruption from the sixth in any 12 month period)	60
Three sewerage interruptions during any 12 month period (from 2018-19 for every sewerage interruption from the third in any 12 month period)	60
Unplanned water supply interruption longer than five hours	60
Sewerage service interruption longer than four hours to restore the service	60
Sewer spill within the premises and we take longer than 1 hour to contain it	1500
Sewer spill we take longer than 5 hours to contain	1000
Beach closure	10,000 paid to a community group affected by the spill
Not restricting the water supply of, or taking legal action against, a residential customer prior to taking reasonable endeavours (as defined by the commission) to contact the customer and provide information about help that is available if the customer is experiencing difficulties paying	500

## Appendix D – rate of return

A submission from the Consumer Action Law Centre (CALC) recommended we set the benchmark cost of debt at five per cent or around one per cent lower than the amount allowed in our draft decision (6.05 per cent per annum in nominal terms). It also recommended that we reduce each of the equity values in the PREMO matrix by one per cent. CALC submits that government owned water corporations carry less risk than private corporations, and as such, the allowed cost of debt and the return on equity should be lowered, compared with the rates allowed in our draft decision.<sup>59</sup> These recommendations are based on a report prepared by CME for CALC.<sup>60</sup>

Victoria's water corporations are subject to the competitive neutrality measures the Victorian government agreed to implement as part of the national competition policy agreement and related reforms.<sup>61</sup> This includes ensuring that borrowing costs reflect an estimate of a water corporation's standalone risk profile and credit rating. We note that:

- Victoria's water corporations do not access debt capital markets directly, but rather, their debt is managed by the state government treasury corporation, through the issuance of government bonds. While the treasury corporation may have access to lower debt funding costs due to government's higher credit rating, the water corporation's borrowing costs do not reflect this. Rather, the water corporations borrow from the state treasury corporation at rates consistent with the risk inherent in the businesses as reflected in their stand-alone credit rating.
- The difference between the government's borrowing costs and the costs faced by water corporations represents consideration due to state taxpayers for accepting the business' credit risk. This is achieved via the Financial Accommodation Levy (FAL), which seeks to ensure the borrowing cost faced by each water corporation reflects the nature of their businesses, not the tax powers of government. If state-owned service providers accessed debt markets directly, then they would face debt financing interest rates that reflected their stand-alone credit ratings.

In keeping with these policy parameters, the approach we take to the cost of debt is to adopt a benchmark rate that applies to all water corporations. The benchmark reflects our estimate of the

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<sup>59</sup> Consumer Action Law Centre 2018, *Cost of debt*, op. cit.

<sup>60</sup> Consumer Action Law Centre 2018, *Cost of debt*, op cit., Appendix A.

<sup>61</sup> We note the Water Services Association of Australia supports application of competitive neutrality principles, see Water Services Association of Australia 2016, *Submission to the Essential Services Commission: A new model for pricing services in Victoria's water sector*, July, p. 11.

efficient financing costs for a privately owned business facing a similar degree of economic risk to a regulated water corporation. We consider this is consistent with the requirements of the WIRO.<sup>62</sup>

Adopting the approach recommended by CALC would mean the allowed rate for the cost of debt may be lower than the rate faced by a benchmark efficient water corporation. As well as being inconsistent with government policy that water corporations pay an estimate of a commercial equivalent borrowing rate, it would also be inconsistent with the WIRO's viability and efficiency objectives. Our approach is also similar to that adopted by other Australian economic regulators.

CALC's submission also recommended a one per cent reduction to each return on equity value in the PREMO matrix.<sup>63</sup> CME proposed the reduction mainly based on comparisons with the return allowed for UK water entities, and its view that government-owned water corporations carry less risk than comparable privately owned businesses.

We believe the most relevant comparisons for the return on equity are other economic regulators in Australia. We note the rate for the return on equity (and the overall regulatory rate of return, comprising the cost of debt and the return on equity) approved in our draft decision are within the range of rates estimated by other Australian-based regulators.<sup>64</sup>

Also, our current view is that the allowed return on equity should not be adjusted to reflect government ownership. In deriving the values for the return on equity in the PREMO matrix, we had regard to the return on equity we had allowed in the past, and the incentives for water corporations to provide high quality price submissions in the interests of their customers.

CME also argues for a reduction in return on equity to reflect the prevailing revenue cap form of price control. This reflects that a revenue cap provides a water corporation with greater revenue certainty than other forms of price control, such as a price cap. We note however, that only one urban water corporation in Victoria (Yarra Valley Water) has a revenue cap form of price control. As well, a revenue cap does not necessarily change the level of systematic risk faced by a water corporation. For example, it is possible that a water corporation operating under a revenue cap is more exposed to cost risks than corporation operating under a price cap.<sup>65</sup>

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<sup>62</sup> Including, in particular, the requirements that our decision have regard to: the promotion of efficiency in regulated industries and the financial viability of the regulated water industry (cl 8(b)(ii) WIRO); efficiency in the industry and incentives for long term investment (s 8A(1)(a) ESC Act); and consistency in regulation between States and on a national basis (s 8A(1)(f) ESC Act).

<sup>63</sup> Consumer Action Law Centre 2018, *Cost of debt*, op. cit.

<sup>64</sup> Essential Services Commission of South Australia 2016, *SA Water regulatory determination 2016*, Final Determination, June; Independent Pricing and Regulatory Tribunal 2017, *WACC biannual update*, August

<sup>65</sup> For example, increases in water demand can lead to increased costs for a water corporation, which would not be matched by an increase in revenue, under a revenue cap. By contrast, under a price cap increases in water demand would also lead to an increase in revenue.

While our final decision has not agreed with CALC’s recommendations, we will re-consider its arguments as part of any future review of the PREMO framework.